STATE OF MICHIGAN
IN THE SUPREME COURT
APPEAL FROM THE MICHIGAN COURT OF APPEALS

EILEEN V. GRAVES
Plaintiff-Appellant,
vs.
AMERICAN ACCEPTANCE MORTGAGE CORPORATION
Defendant-Appellee,
and
BOULDER ESCROW, INC.,
Counter and Cross-Plaintiff –Appellee.
and
STEVE A. DIAZ,
Counter and Cross-Defendant.
_____/

Supreme Court No. 19977

Court of Appeals No. 215141

Oakland County Circuit Court
No. 96-511648-CZ

The Real Property Law Section of the State Bar of Michigan (the "Section") is a non-profit voluntary association of Michigan attorneys who specialize in real estate law. The position expressed herein is that of the Section only and not necessarily that of the State Bar of Michigan whose policy-making bodies have not considered the issues.

AMICUS CURIAE REAL PROPERTY LAW SECTION OF THE STATE BAR OF MICHIGAN'S BRIEF ON APPEAL

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STATEMENT OF FACTS

John and Paula Giordano agreed to sell certain property (the "Property") to "Steve A. Diaz and Eileen V. Pretto, his wife" pursuant to a land contract dated August 25, 1987. *See* Exhibit A, Plaintiff Eileen V. Graves's Application for Leave to Appeal (the "Appeal Application").

The "Withdrawal Judgment of Divorce" (the "Divorce Order"), which was entered in 1994 and recorded on September 7, 1994 (*see* Exhibit B, Appeal Application), provides as follows with respect to the Property:

> IT IS FURTHER ORDERED AND ADJUDGED that the real property located at 72 West End, Waterford, Michigan, shall be awarded to the Plaintiff [Steve A. Diaz] subject to a lien in favor of the Defendant [Eileen V. Pretto] in the amount of seven (7%) percent interest per annum payable within one year from March 30, 1994, for the following debts which Plaintiff owes to the Defendant: 1) Any child support arrearages; 2) Rental arrearages in the amount of Nine Hundred ($900.00) Dollars relative to the property at 1048 LaSalle, Waterford, Michigan; 3) Any arrearages owed on the land contract relative to the 1048 LaSalle, Waterford, Michigan as of March 31, 1994. These arrearages amount to Seven Thousand Five Hundred Four ($7,504.00) Dollars. That the Plaintiff shall assume any outstanding obligation thereon and hold the Defendant harmless therefrom. That the Plaintiff shall be awarded the furniture, furnishings and appliances located at said property free and clear of any claim or interest of the Defendant.

According to the Court of Appeals decision, the Property was transferred to Diaz by a warranty deed "subject to acts or admissions of grantee since 8-25-87 being the date of a certain land contract in fulfillment of which this deed is given," and the deed was executed on September 13, 1994, and recorded on October 6, 1994.

Diaz obtained money to pay off the land contract through a loan secured by a mortgage on the Property (the "Mortgage"), which was executed on September 7, 1994, and recorded on October 5, 1994. *See* Exhibit C, Appeal Application.

ARGUMENT

I. *THE COURT OF APPEALS DECISION INCORRECTLY TREATS THE LAND CONTRACT AS A MERE SALES AGREEMENT AND FAILS TO RECOGNIZE THE CONTINUING SPECIAL STATUS OF LAND CONTRACTS UNDER MICHIGAN LAW, AS EVIDENCED BY RECENT LEGISLATION.*

The Real Property Law Section of the State Bar of Michigan supported Plaintiff Eileen V. Graves' Application for Leave to Appeal because the Court of Appeals decision (a) did not recognize the special status of land contracts under Michigan law and practice and (b) would undermine the viability of the land contract financing scheme enacted by the Michigan Legislature in the land contract mortgage act (MCL 565.356 *et seq*).

Because land contracts have been given a special status under Michigan law, case law from other jurisdictions has limited value. As a result, although the reasoning in the Court of Appeals' decision was logical, it reached an incorrect result because it relied on cases from other jurisdictions that are not applicable in the context of Michigan law. Application of Michigan case law -- which is consistent with and supported by recent legislation acknowledging the special status of land contracts in Michigan -- compels the conclusion that the Court of Appeals decision was incorrectly decided.

In 1998 the Michigan legislature adopted legislation that establishes detailed procedures for mortgaging land contract interests: Although land contracts are still commonly used in Michigan as a means of financing the sale of real estate (particularly seller financing), because of the special nature of land contracts, it was difficult to finance and mortgage the seller's and buyer's interests under a land contract. Consequently, an *ad hoc* committee of the Section drafted legislation to provide the certainty required to provide a viable environment for

mortgaging land contract interests. This proposal was enacted as Public Act 106 of 1998. MCL 565.356 *et seq.*[1]

The Court of Appeals decision would have rendered financing under the land contract mortgage act virtually impossible because the mortgagee of a land contract vendee interest would have no assurance that it would retain its bargained for priority. Under the Court of Appeals decision in *Graves*, a subsequent mortgagee who provides financing to pay off the land contract would take priority over the prior recorded land contract mortgagee. Thus that decision would have effectively made the recent legislation meaningless and would have reintroduced the paralyzing uncertainty that the legislation was intended to resolve.

II. *UNDER MICHIGAN LAW A LAND CONTRACT IS THE EQUIVALENT OF A PURCHASE-MONEY MORTGAGE; CONSEQUENTLY A MORTGAGE LOAN USED TO PAY OFF A LAND CONTRACT CONSTITUTES A REFINANCING THAT IS NOT ENTITLED TO PURCHASE-MONEY SUPER PRIORITY.*

The Michigan Supreme Court has previously held that a land contract creates a relationship in which the vendee holds equitable title and the vendor holds legal title only, resulting in the vendor holding the equivalent of a purchase-money mortgage. *City of Marquette v Michigan Iron & Land Co.*, 132 Mich. 130, 132-33, 92 N.W. 934 (1903). As the Court explained:

> The vendor has, in effect, exchanged his property for the unconditional obligation of the vendee, the performance of which is secured by the retention of the legal title. ... The obligations

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[1] The unique nature of this treatment of land contracts and the Michigan legislature's continuing interest is illustrated by the recent enactment of Revised Article 9 of the Uniform Commercial Code. The scope of Article 9 has been expanded to include liens that secure a promissory note or other obligation subject to Revised Article 9. So, for example, if a lender holds a promissory note that is secured by a mortgage on real estate, and the lender wishes to grant a lien on its own interests in the note and related mortgage, Revised Article 9 now provides the rules regarding the creation and priority of the lien on the lender's interest. In adopting the provisions that implement this expanded scope, the Michigan legislature adopted a non-uniform provision that excludes interests relating to mortgages of land contract vendor and vendee interests.. MCL 440.9109(l). This non-uniform exception to Revised Article 9 was added at the request of the Section because of the special status of land contracts.

> under consideration, therefore, resemble, not ... promises to buy merchandise and products to be delivered in the future, but credits secured by mortgages. The resemblance between these obligations and credits secured by purchase-money mortgages may best be described by stating that they differ only in this: That the vendor has a remedy to enforce his rights which is not given to the mortgagee, namely he may take immediate possession of his security. Such an inconsequential difference affords no ground for a legal distinction.

The crux of the Court of Appeals' decision in the *Graves* case is its conclusion that the final transfer of legal title, as opposed to the initial transfer of equitable title, is the critical step. The fallacy in the decision is the Court's reliance on law from other states that treats a land contract as merely a contract for sale. As the Supreme Court itself noted in the *Marquette* case, cases from other states that analyze a land contract as a conditional sale are not applicable because land contracts "construed according to the laws of Michigan, as they must be, do not 'set forth a conditional sale only,' but do, as we have already shown, transfer an equitable title to the vendee." *Marquette*, 132 Mich. at 134.

If a land contract is itself the equivalent of a purchase-money mortgage, then a subsequent mortgage incurred to pay off the land contract constitutes a refinancing, which even the Court of Appeals would acknowledge is not entitled to purchase-money super priority.

The Defendant's argument that a land contract vendee's interest prior to payment of the land contract is a different estate in land than it holds after payment is similarly misguided. Just as holding title to property subject to a mortgage does not mean that an entirely new estate is created when the mortgage is paid off, the equitable title of a land contract vendee is not an entirely different estate than the estate it holds after the land contract is paid off. Consequently, the lien granted in the Divorce Order encumbers the interest of Diaz that is subject to the Mortgage.

III. ***THE MORTGAGE IS NOT ENTITLED TO THE BENEFIT OF MCL 565.29, AND THUS IS SUBJECT TO THE DIVORCE ORDER LIEN, BECAUSE (A) IF RECORDING THE DIVORCE ORDER PRIOR TO THE DEED CONSTITUTES A RECORDING DEFICIENCY, THE MORTGAGE IS SUBJECT TO THE SAME DEFICIENCY, AND (B) THE MORTGAGEE HAD INQUIRY NOTICE OF THE INTEREST OF DIAZ'S FORMER WIFE IN THE PROPERTY, AND THUS IS NOT A BONA FIDE PURCHASER ENTITLED TO CUT OFF THE DIVORCE ORDER LIEN.***

The Michigan Land Title Association ("MLTA") argues in support of Defendant's motion for rehearing that the Divorce Order is outside the "chain of title," and thus is not protected by Michigan's "race-notice' statute.

However, MCL 565.29 provides that a conveyance that is not "recorded as provided in this chapter" is "void as against any subsequent purchaser in good faith ... *whose conveyance shall first be duly recorded*" (emphasis added).

MLTA argues that the Divorce Order is deficient and is not entitled to the benefit of the priority established through the recording statutes because the Divorce Order was recorded before the deed to Diaz, and thus was outside the chain of title. However, if that argument is correct, the Mortgage is also not entitled to the benefit of MCL 565.29 because *the Mortgage is similarly outside the chain of title*: The deed conveying the Property to Diaz was recorded on October 6, 1994 (according to footnote 1 of the Court of Appeals decision), while the Mortgage was recorded the day before on October 5, 1994. Consequently, *even if* recording a document outside of the chain of title is a deficiency that means that document is not entitled to the priority established under the recording statutes, the Divorce Order is not void as against the mortgagee under MCL 565.29 because the Mortgage also does not constitute a conveyance that was "duly recorded."

In addition, MCL 565.29 is applicable only to a "purchaser in good faith," which has been interpreted to mean that the subsequent interest holder does not have notice of the prior

interest. In this context notice can be actual or constructive. This includes record notice of items in the chain of title, as well as constructive notice arising from physical possession of property. It also includes the concept of "inquiry notice:"

> If [the subsequent interest holder] has knowledge of such facts as would lead any honest man, using ordinary caution, to make further inquiries, and does not make, but on the contrary studiously avoids making such obvious inquiries, he must be taken to have notice of those facts, which, if he had used such ordinary diligence, he would readily have ascertained.

American Cedar & Lumber *Co. v. Gustin*, 236 Mich. 351, 361, 210 N.W. 300 (1926) (quoting *Converse v. Blumrich*, 14 Mich. 109 (90 Am Dec 230)).

In *Solomon v. Shewitz*, 185 Mich. 620, 152 N.W. 196 (1915), a seller (a) first obtained an option to purchase land, (b) then entered into an unrecorded agreement to sell that land (which was found by the court to constitute a land contract) to a second party, and (c) finally exercised his option to purchase the land and sold it to a third party. The case turned on whether the third party was a *bona fide* purchaser that could cut off the unrecorded land contract vendee's interest of the second party.

The third party was aware that the seller had some sort of agreement, but relied on the seller's representation that the agreement was an option that had expired. The court found that the third party had notice of the land contract that was sufficient to put him on inquiry as to the second party's land contract vendee rights, and thus the third party was not a bona fide purchaser entitled to cut off the second party's vendee rights.

In this case, the deed transferring title to Diaz specifically referenced the fact that it was in fulfillment of a land contract. The land contract clearly provided that both Diaz and "his wife" were the purchasers. A determination of the status of the wife's interest would necessarily involve review of the Divorce Order. The same sentence in the Divorce Order that granted the

Property to Diaz also granted a lien on the Property to his former wife. Consequently, the mortgagee clearly had sufficient notice to require an inquiry that would have disclosed the liens granted in the Divorce Order, and consequently, it was not a *bona fide* purchaser entitled to cut off those liens.

IV. *UNDER CURRENT LAW, THE PRIORITY OF A MORTGAGE LOAN IS GENERALLY DETERMINED BY THE DATE OF RECORDING.*

Until recently, the priority of a mortgage depended on the date on which the obligation secured by the mortgage was incurred, as well as the date the mortgage was recorded. As articulated by the Supreme Court in *Ladue v The Detroit & Milwaukee Railroad Co.*, 13 Mich. 380 (1865):

> [T]he mortgage instrument, without any debt, liability or obligation secured by it, can have no present legal effect as a mortgage or an incumbrance upon the land. It is but a shadow without a substance, an incident without a principal; and it can make no difference in the result whether there has once been a debt or liability which has been satisfied, or whether the debt or liability to be secured has not yet been created. It requires some future agreement of the parties to give it existence. At most, the difference is only between the nonentity which follows annihilation, and that which precedes existence.

Thus, as discussed in *Ladue*, if a mortgage was recorded securing a subsequent discretionary advance, and there was a lien intervening between the date of the mortgage and the subsequent advance, the intervening lien had priority. (It was generally believed that the priority of an obligatory advance would be determined based on the date that the lender became obligated to make the advance, as opposed to the date the advance was actually made.)

This was the state of the law on mortgage priority during the entire period that case law regarding the potential super priority of purchase-money mortgages was being developed. In other words, one of the concepts underlying the analyses was the principle that a mortgage did

not have independent existence, and determining mortgage priority required more than simply identifying which document was recorded first.

This situation changed dramatically in 1990 with enactment of the future advance mortgages act (MCL 565.901 *et seq*). As a general rule, if a mortgage secures "future advances" by its terms, then the priority of all of the future advances (together with all outstanding advances) relates back to the date of recording the mortgage.[2] This statute can be seen as expression of a legislative intent to establish a pure "race-notice" regime for mortgage liens, with limited exceptions for construction liens and taxes as set forth in MCL 565.905. In light of this development, it can be argued that purchase money mortgages are no longer entitled to take priority over a prior recorded liens.

V. *TO THE EXTENT THAT PURCHASE-MONEY SUPER PRIORITY CONTINUES TO SURVIVE, ARGUABLY IT SHOULD BE LIMITED TO SELLER FINANCING.*

As discussed in the preceding section, it is not clear that the concept of purchase-money super priority remains a viable concept. However, to the extent that it survives, an argument can be made that only *seller* financing is entitled to purchase-money super priority. Giving a mortgage priority over previously recorded encumbrances is difficult to reconcile with the statutory concept that, as a general rule, priority between encumbrances of real estate interests is based solely on order of recording. One way to reconcile the statutory race-notice recording priority with the concept of a purchase-money super priority is to analyze the purchase-money

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[2] The statute as originally enacted was subsequently modified to add certain additional requirements for residential mortgages, including a requirement that a residential mortgage include a cap on the amount of future advances that would be entitled to the recording date priority. These changes were made to accommodate the needs of lenders providing home equity lines of credit, since (a) this type of financing was typically secured by a junior lien, (b) the standard residential mortgage forms secured future advances, and (c) it was not practical to negotiate a subordination agreement in each case. However, even as modified, the statute still embodies the principle that the priority of a mortgage is generally determined based on the date of recording.

transaction as a single transaction, with the title passing by deed being subject to the mortgage interest retained by the seller.[3]

After discussing the effect of the recording statutes, the Court of Appeals asserted in its decision that: "It is well established, however, that a promptly recorded purchase-money mortgage takes priority over earlier creditors' interests, notwithstanding that the earlier interests were duly recorded," citing *Fecteau v Fries*, 253 Mich. 51, 234 N.W. 113. However, *Fecteau* stands for the proposition that only a purchase-money mortgage given by a *seller* is entitled to priority.

In *Fecteau* the Supreme Court addressed the relative priority of two mortgages, both of which were incurred to finance a part of the purchase price. One mortgage was given to a third party to finance the down payment, and the second mortgage was given to the vendor to finance the balance of the purchase price. In this case, the mortgage to the third party was given before the purchaser acquired title, and the third party's mortgage was recorded before the vendor's mortgage. When the mortgages were foreclosed, each mortgagee claimed priority. The Circuit Court held that the two mortgages arose out of a single transaction, had no priority over each other, and were each entitled to a pro-rata share of the sale proceeds. The Supreme Court disagreed, quoting cases from Missouri and New York as follows (*id.* at 53-54):

> "A mortgage given to a vendor to secure an unpaid balance of purchase-money of land and recorded on the same day, has priority of one which is given by the vendee, before he has concluded the purchase, to a person who furnishes him the money to make the cash payment, notwithstanding the latter is recorded first."

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[3] This concept that the conveyance by the seller is indivisible from the seller purchase-money mortgage has been applied in various contexts. For example, (a) a minor, who would otherwise be entitled to disaffirm a mortgage on coming of age, cannot disaffirm a seller's purchase-money mortgage because the minor cannot affirm the deed while disaffirming the mortgage since they are an integral transaction, and (b) a wife does not need to sign a seller's purchase-money mortgage since the right of dower only attaches to the spouse's interest, which is at all times subject to the mortgage. *See, e.g., Young v McKee*, 13 Mich. 552, 556 (1865).

> The mortgage to Patterson [third party financing down payment] could not insert itself between the deed to Fries [buyer] and the purchase-money mortgage by Fries to plaintiffs [seller]. ...
>
> "The deed and Bowen (Fecteau) [seller] mortgage executed at the same time are to be construed together as one instrument. They constitute an indivisible act. There never was a moment between the seisin and mortgage when LaGrange (Fries) [buyer] could encumber the estate, to the exclusion of the latter, and it follows that a prior mortgage could not insert itself between them."

For the same reason, a land contract is the simultaneous transfer of equitable title and retention of the legal title to secure repayment of the purchase price. The transfer and retention of security for the debt is indivisible, and there is never a moment when the interest of one or the other could be encumbered separately.

Thus, the case cited by the Court of Appeals to support the proposition that a purchase-money mortgage is entitled to priority actually holds that a purchase-money mortgage (meaning the proceeds are used to obtain title to property) is entitled to purchase-money super priority only if it is given to a seller.

CONCLUSION

For the reasons set forth above, the Mortgage is not entitled to priority over the lien granted in the Divorce Order:

It is not clear that the potential super priority status of purchase money financing remains a viable concept. To the extent that it does, (1) the land contract constitutes purchase money financing and the Mortgage constitutes a refinancing, and thus the Mortgage is not entitled to super priority; and (2) arguably purchase money super priority should be limited to seller financing, so that again, the Mortgage is not entitled to a super priority.

The liens granted in the Divorce Order encumber Diaz's interest in the Property. Since the Divorce Order was recorded prior to the Mortgage, the Mortgage is subject to the liens

granted in the Divorce Order. To the extent that recordation of the Divorce Order prior to recordation of the deed means that it is not in the chain of title, and is thus not entitled to the benefit of the recording statutes, the same is true of the Mortgage. In addition, the mortgagee was on inquiry notice of the interests of Diaz's former wife, and thus was not a *bona fide* purchaser entitled to cut off the liens of the Divorce Order pursuant to MCL 565.29.

Based on the foregoing, the Section prays that Court of Appeals be reversed on its ruling that the Mortgage is entitled to priority over the Divorce Order.

Respectfully submitted,

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